

## Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03

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FM AMEMBASSY ROME

TO SECSTATE WASHDC 9452

INFO AMEMBASSY BONN

USMISSION EC BRUSSELS

AMEMBASSY LONDON

AMCONSUL MILAN

AMCONSUL NAPLES

AMEMBASSY PARIS

USMISSION OECD PARIS

AMCONSUL FLORENCE

AMCONSUL GENOA

AMCONSUL PALERMO

AMCONSUL TRIESTE

AMCONSUL TURIN

C O N F I D E N T I A L SECTION 1 OF 2 ROME 13295/1

E.O. 11652: N/A

TAGS: EFIN, IT

SUBJ: BANK OF ITALY PERFORMANCE UNDER GOVERNOR BAFFI

PASS TREASURY AND FRB

REF: ROME 12199

SUMMARY. FOLLOWING IS ATTEMPT TO ASSESS PERFORMANCE OF  
BANK OF ITALY IN YEAR SINCE LONG-TIME GOVERNOR GUIDO CARLI  
STEPPED DOWN AND PAOLO BAFFI WAS NAMED GOVERNOR OF BANK.  
ON QUESTION OF POLICY PERFORMANCE BOI HAS CONTINUED TO  
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FOLLOW BASIC APPROACH ESTABLISHED BY CARLI DURING HIS

FIFTEEN-YEAR TENURE, GIVING HIGH PRIORITY TO FIGHTING INFLATION AND MAINTAINING BALANCE OF PAYMENTS EQUILIBRIUM. RESULTS HAVE NOT BEEN GOOD BUT CAUSES OF FAILURE LIE LARGELY OUTSIDE BOI CONTROL. IN MANAGEMENT OF BANK OF ITALY, BAFFI SEEMS TO BE FOLLOWING MORE TRADITIONAL APPROACH THAN CARLI, WHICH HAS PROBABLY CONTRIBUTED TO SOME DISCONTENT AND JOCKEYING FOR POSITION WITHIN YOUNGER GENERATION IN BOI STAFF. END SUMMARY.

1. MANAGEMENT OF MONETARY AND FOREIGN EXCHANGE POLICIES. AS EMBASSY FORESAW IN REFTTEL, BASIC AIMS PURSUED BY BOI UNDER CARLI HAVE BEEN ADOPTED BY BAFFI, I.E., PRIORITY FOR RESTRAINT OF INFLATION AND FOR BALANCE OF PAYMENTS EQUILIBRIUM. FORCE OF EVENTS HAVE LARGELY DETERMINED THESE PRIORITIES. IN FIRST YEAR OF HIS REGIME, GOVERNOR BAFFI HAS HAD RELATIVELY LITTLE SUCCESS IN ACHIEVING EITHER GOAL. HOWEVER, IT WOULD BE UNFAIR TO COMPARE HIS PERFORMANCE IN PAST YEAR WITH THAT OF CARLI DURING PREVIOUS ECONOMIC CRISES. THIS IS BECAUSE CAUSES AND MAGNITUDE OF ITALY'S INFLATIONARY AND BALANCE OF PAYMENTS PROBLEMS DIFFER SIGNIFICANTLY FROM THOSE FACED BY CARLI. MAIN CAUSES LEADING UP TO ITALY'S PRESENT ECONOMIC WOES ARE: SHARPLY RISING LABOR COSTS, GROWING CASH BUDGET DEFICIT, FIXED EXCHANGE RATE (UNTIL RECENTLY) AND DRAMATIC WORSENING IN ITALY'S TERMS OF TRADE. BEGINNING ABOUT 1969-1970, EXCESSIVE INCREASES IN LABOR COSTS AND BURGEONING CASH BUDGET DEFICIT BEGAN TO BE SERIOUS PROBLEMS. THESE TWO FACTORS INCREASINGLY LED TO PRICE INFLATION AND A REDUCTION IN ITALY'S COMPETITIVENESS IN WORLD MARKETS. AT SAME TIME, INTERNATIONAL COMMITMENTS AND/OR DOMESTIC POLICY PREFERENCES LIMITED USE OF EXCHANGE RATE AS INSTRUMENT OF ECONOMIC MANAGEMENT. SUBSEQUENTLY, ITALY'S TERMS OF TRADE WORSENE DRAMATICALLY, FIRST IN 1973 WITH RISE IN FOOD AND INDUSTRIAL RAW MATERIAL PRICES DURING SYNCHRONIZED BOOM IN INDUSTRIAL WORLD, THEN IN 1974 DUE TO SHARP INCREASE IN PETROLEUM PRICES AND FINALLY IN 1976 DUE TO LIRA DEPRECIATION. DURING THIS PERIOD BOI WAS NOT IN A POSITION SERIOUSLY TO RESIST DEMANDS OF LABOR UNIONS, TO DISCOURAGE INCREASE IN BUDGET EXPENDITURES, OR TO AFFECT GROWTH OF TAX REVENUES. AT SAME TIME, CONFIDENTIAL

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BEGINNING IN 1972 WHEN WEAKENING IN BALANCE OF PAYMENTS BECAME EVIDENT, CARLI ATTEMPTED TO BUY TIME TO ALLOW FOR ADJUSTMENT IN ITALY'S BALANCE OF PAYMENTS BY ENGAGING IN MASSIVE BORROWING IN EUROMARKETS. RESULT WAS ACCUMULATION OF FOREIGN DEBT AND EXHAUSTION OF ITALY'S EUROMARKET BORROWING AVAILABILITIES EVEN BEFORE ENERGY CRISIS OCCURRED.

2. THUS, WHEN GOVERNOR BAFFI TOOK OVER THE BANK IN MID-

1975, HE INHERITED A SITUATION IN WHICH: (1) ITALY HAD ACCUMULATED ABOUT \$12-13 BILLION IN FOREIGN COMPENSATORY BORROWINGS AND ITS FOREIGN CREDIT RATING WAS DECIDEDLY POOR; (2) ITS BALANCE OF PAYMENTS WAS STILL IN DEFICIT AND WOULD HAVE BEEN IN LARGER DEFICIT EXCEPT FOR 1975 RECESSION; (3) PRICE INFLATION, ALTHOUGH SOMEWHAT IMPROVED, WAS STILL AMONG HIGHEST OF INDUSTRIAL COUNTRIES; (4) CASH BUDGET DEFICIT IN 1975 AMOUNTED TO 12.5 PERCENT OF GDP AND ITS FINANCING PRE-EMPTED ABOUT 44 PERCENT OF ALL NEW CREDIT; AND (5) WAGE RATES IN INDUSTRY (DESPITE THE RECESSION) ROSE BY ABOUT 28 PERCENT. AT SAME TIME, GOI WAS UNDER STRONG PRESSURE TO TAKE ANTI-RECESSION ACTION. BUDGET EXPENDITURE PACKAGE HAD JUST BEEN SUBMITTED TO PARLIAMENT AND BANK OF ITALY WAS BEING PRESSED TO RELAX MONETARY POLICY. ALSO, TREAS MINISTER COLOMBO WAS BEING CRITICIZED FOR NOT FORCING COMMERCIAL BANK CARTEL TO REDUCE INTEREST RATES. TO SOME EXTENT BOI AND COLOMBO TRIES TO RESIST THESE PRESSURES. FOR EXAMPLE, CREATION OF SPECIAL TEMPORARY EXPORT CREDIT DISCOUNT FACILITY LATE IN 1975 WAS ASSIGNED TO ITALIAN EXCHANGE OFFICE INSTEAD OF TO BOI ITSELF BECAUSE BOI DID NOT WISH TO ESTABLISH PRECEDENT OF GRANTING OPEN-ENDED DISCOUNT FACILITY.

3. SHARP INCREASE IN LIQUIDITY IN LAST QUARTER OF 1975 FED INFLATION AND CONTRIBUTED TO BALANCE OF PAYMENTS DEFICIT. TO CONSIDERABLE EXTENT, INCREASE IN LIQUIDITY WAS DUE TO LARGE CASH BUDGET DEFICIT OVER WHICH BOI HAD NO CONTROL AND PERSISTENT DEFENSE OF LIRA EXCHANGE RATE CAN BE PARTIALLY EXCUSED ON GROUNDS THAT BALANCE OF PAYMENTS THROUGH FIRST TEN MONTHS OF YEAR HAD BEEN IN APPROXIMATE EQUILIBRIUM AND THAT EXCHANGE LOSSES IN LAST TWO MONTHS OF YEAR MERELY REPRESENTED ONE TIME COST DUE

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TO RESTOCKING OF IMPORTED INVENTORIES. IN RETROSPECT, HOWEVER, BANK MANAGEMENT CAN BE CRITICIZED FOR NOT HAVING RECOGNIZED SOONER ITS INABILITY TO DEFEND LIRA RATE. IT MIGHT EVEN BE ARGUED THAT BOI AND GOI SHOULD HAVE BEGUN TO ALLOW RATE TO DEPRECIATE EARLY IN 1975 (DESPITE TEMPORARY BALANCE OF PAYMENTS EQUILIBRIUM) IN ANTICIPATION OF EXPECTED WORSENING OF BALANCE OF PAYMENTS IN 1976 AND OF EVENTUAL NEED TO PAY OFF ITALY'S LARGE FOREIGN DEBT. (HOWEVER, SUCH A POLICY MIGHT WELL HAVE ENCOUNTERED OPPOSITION FROM ITALY'S EC PARTNERS.) EVEN IF BOI MANAGEMENT HAD PERCEIVED NEED TO LET LIRA FLOAT FREELY, IT WOULD STILL HAVE BEEN COMPELLED TO FOLLOW GUIDELINES ESTABLISHED BY GOI WHICH, FOR REASONS OF CONFIDENCE AND FEAR OF INFLATIONARY FEEDBACK, WAS RELUCTANT TO LET RATE GO. STILL, BOI MIGHT HAVE

BEEN MORE SUCCESSFUL HAD IT TRIED SOONER TO CONVINCE GOI.

4. IN FACE OF CONTINUED CONSTRAINTS ON ABILITY OF BANK  
OF ITALY TO CONTROL MONETARY POLICY DUE TO LABOR COSTS  
AND BUDGET DEFICIT PROBLEMS, BOI UNDER BAFFI REGIME HAS  
MADE SERIOUS EFFORT TO "GO TO THE PUBLIC" TO CONVINCE

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R 161415Z AUG 76

FM AMEMBASSY ROME

TO SECSTATE WASHDC 9453

AMEMBASSY BONN

USMISSION EC BRUSSELS

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AMCONSUL MILAN

AMCONSUL NAPLES

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AMCONSUL GENOA

AMCONSUL PALERMO

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C O N F I D E N T I A L SECTION 2 OF 2 ROME 13295

POLITICIANS AND LABOR LEADERS OF SERIOUSNESS OF PROBLEMS.  
BOI CAMPAIGN HAS BEEN COMPLEMENTED BY SIMILAR EFFORTS BY  
ACADEMIC AND GOVERNMENT ECONOMISTS. RESULT HAS BEEN  
GROWING WILLINGNESS ON PART OF ITALIAN PUBLIC TO  
ACCEPT NEED FOR MEASURES IN NEW ANDREOTTI GOVERNMENT  
ECONOMIC PROGRAM WHICH ADDRESS THESE ISSUES.

5. ALTHOUGH BOI UNDER BAFFI HAS HAD TO CONCENTRATE ITS ATTENTION ON ABOVE MAJOR ISSUES, THERE IS SOME EVIDENCE THAT LONGER-TERM BANK APPROACH TO MONETARY POLICY WILL BE SOMEWHAT LESS "DIRIGISTE" THAN UNDER CARLI. WHILE THERE WAS NEVER ANY QUESTION ABOUT CARLI'S DEDICATION TO CONFIDENTIAL

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FREE MARKET APPROACH TO ECONOMIC POLICY MANAGEMENT, BANK WAS RATHER FREQUENTLY FORCED TO ADOPT EMERGENCY MEASURES TO DEAL WITH URGENT PROBLEMS. ON SUCH OCCASIONS, AN INNOVATOR LIKE CARLI WAS LESS RELUCTANT THAT THE MORE CONSERVATIVE BAFFI TO EXPERIMENT WITH USE OF DIRECT CONTROLS. WHILE SOME RECENT ACTIONS TAKEN BY BOI, SUCH AS SIMPLIFICATION OF RESERVE REQUIREMENTS AND REDUCTION IN CENTRAL BANK SUPPORT OF BOND MARKET, ARE PARTLY DUE TO FORCE MAJEURE, THEY MAY ALSO BE MORE CONSISTENT WITH BAFFI'S APPROACH TO MONETARY POLICY THAN WOULD HAVE BEEN THE CASE UNDER CARLI.

6. BOI-TREASURY RELATIONS. MUCH HAS BEEN WRITTEN IN ITALIAN PRESS ABOUT ALLEGED BAD BLOOD BETWEEN BOI AND TREASURY FOLLOWING 1975 APPOINTMENT OF FERDINANDO VENTRIGLIA AS DIRECTOR GENERAL OF TREASURY. TO SOME EXTENT, THIS MAY BE DUE TO CLASH OF PERSONALITIES AND TO FACT THAT VENTRIGLIA WAS UNSUCCESSFUL CANDIDATE FOR BOI GOVERNORSHIP. HOWEVER, EQUALLY IMPORTANT SEEM TO BE TWO OTHER FACTORS: (1) DEDICATION OF VENTRIGLIA TO "KEYNESIAN" APPROACH TO PROBLEM OF 1975 RECESSION, IN WHICH HE SEEMED TO FAVOR EASY FISCAL POLICY, AND (2) DESIRE OF VENTRIGLIA TO ESTABLISH TREASURY AS MORE EQUAL PARTNER WITH BOI IN FORMULATION OF ITALIAN FINANCIAL POLICIES. ON FIRST QUESTION, VENTRIGLIA IS WIDELY BELIEVED TO HAVE SUPPORTED ANTI-RECESSION EFFORTS OF GOI BEYOND PERIOD WHEN POLICY SHIFT SHOULD HAVE BEEN MADE TOWARD SOMEWHAT GREATER RESTRAINT TO TAKE INTO ACCOUNT INFLATIONARY AND BALANCE OF PAYMENTS PROBLEMS. ALSO, BEING CLOSELY ASSOCIATED WITH MINISTER COLOMBO AND WITH CHRISTIAN DEMOCRATIC PARTY (DC), VENTRIGLIA APPARENTLY WAS RELUCTANT TO RECOMMEND FREE FLOAT OF LIRA LATE IN 1975 BECAUSE OF CONCERN ABOUT EFFECT ON CONFIDENCE IN DC AND IN MORO-LA MALFA GOVERNMENT. REGARDING RELATIONSHIPS BETWEEN BOI AND TREASURY, VENTRIGLIA'S PREDECESSORS WERE VERY MUCH DEPENDENT ON TECHNICAL EXPERTISE OF BOI AND, THUS, WERE IN RELATIVELY WEAK POSITION VIS-A-VIS BOI IN POLICY DISPUTES. WHILE FINAL WORD RESTED WITH TREASURY MINISTER, HIS TOP STAFF WERE OFTEN OUTGUNNED BY BOI TECHNICIANS. NOT TOO SURPRISINGLY, VENTRIGLIA APPARENTLY HAS SOUGHT TO REDRESS CONFIDENTIAL

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THE BALANCE BETWEEN THE TWO INSTITUTIONS. (ITALIAN PRESS IS NOW SPECULATING AS TO WHETHER VENTRIGLIA WILL REMAIN AS DIRECTOR GENERAL UNDER NEW TREASURY MINISTER STAMMATI. CONSEQUENTLY, BOI-TREASURY RELATIONSHIP MAY BE ABOUT TO UNDERGO FURTHER CHANGES.)

7. MANAGEMENT OF BANK. DURING HIS LONG TENURE AS GOVERNOR CARLI HIRED LARGE GROUP OF BRIGHT YOUNG ECONOMISTS. HE WAS THEN INCLINED TO GO DIRECTLY TO MOST CAPABLE INDIVIDUAL IN SPECIFIC ECONOMIC FIELD TO SEEK INFORMATION OR ADVICE RATHER THAN STRICTLY TO RESPECT ORGANIZATIONAL CHART. IN CONTRAST, IT APPEARS FROM EMBASSY CONTACTS WITH BOI STAFF THAT GOVERNOR BAFFI IS MORE INCLINED TO FOLLOW NORMAL CHAIN OF COMMAND. THIS CHANGE IN APPROACH, PLUS THE FACT THAT MANY YOUNG ECONOMISTS IN BOI ARE REACHING AN AGE AND DEGREE OF EXPERIENCE AT WHICH THEY EXPECT TO BE GIVEN PROMOTIONS TO MORE RESPONSIBLE POSITIONS, SEEMS TO HAVE CREATED SOME DISCONTENT AND FERMENT INSIDE BANK. ALSO, COMING OF AGE OF YOUNGER GENERATION MEANS THAT THERE SIMPLY ARE NOT ENOUGH TOP JOBS TO GO AROUND. RESULT IS JOCKEYING FOR POSITION WITHIN BANK AND SOME DEPARTURE OF DISSATISFIED EMPLOYEES FROM BANK, (E.G., RECENT CASE OF PAOLO SAVONA WHO, HOWEVER, LANDED ON HIS FEET BY BEING NAMED DIRECTOR GENERAL OF CONFIDUSTRIA.)

8. TURN-OVER AT TOP OF BOI IS NOT YET COMPLETE. AS PREVIOUSLY REPORTED, DR. RINALDO OSSOLA, WHO WAS PROMOTED TO DIRECTOR GENERAL ONLY A YEAR AGO, HAS ALREADY RESIGNED FROM THE BANK (WITHOUT FOREKNOWLEDGE OF HIS SUBSEQUENT APPOINTMENT AS MINISTER OF FOREIGN TRADE). REASON FOR RESIGNATION, AS GIVEN BOTH PUBLICLY AND PRIVATELY BY OSSOLA, WAS TO PERMIT "INTERNAL SOLUTION" OF SUCCESSION PROBLEM AT TOP LEVEL OF BANK. OSSOLA HOPED THAT HIS RESIGNATION WOULD PERMIT DESIGNATION OF VICE DIRECTOR GENERAL ERCOLANI AS DIRECTOR GENERAL AND WOULD PERMIT YOUNGER MEMBER OF STAFF TO MOVE INTO ERCOLANI SLOT. WHILE FINAL NOMINATIONS HAVE NOT YET BEEN MADE, IT APPEARS THAT OSSOLA'S PLAN MAY BE WORKING.

9. COMMENT. ON BALANCE, IT APPEARS THAT MANAGEMENT OF

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BOI SINCE DEPARTURE OF CARLI HAS BEEN AS GOOD AS COULD BE EXPECTED, GIVEN ITALY'S DIFFICULT ECONOMIC SITUATION.

BANK'S MANAGEMENT OF LIQUIDITY AND OF EXCHANGE RATE INTERVENTION POLICIES LATE IN 1975 CAN BE CRITICIZED, BUT THERE ARE FEW CENTRAL BANK MANAGEMENTS WHICH HAVE NOT MADE SIMILAR ERRORS. TO SOME EXTENT, BAFFI REGIME WILL PROVE TO BE TRANSITIONAL PHASE IN HISTORY OF BOI. SINCE BAFFI IS 65 YEARS OLD, HE IS NOT APT TO REMAIN FOR VERY LONG AS GOVERNOR. ALSO, DURING HIS PRESUMABLY BRIEF TENURE ABILITY OF BOI TO RESUME REASONABLE CONTROL OVER MONETARY POLICY IS LIKELY TO BE STRICTLY LIMITED, DEPENDING UPON SUCCESS OF ANDREOTTI GOVERNMENT'S PLANNED STABILIZATION PROGRAM. IF THAT PROGRAM IS REASONABLY SUCCESSFUL IN DEALING WITH LABOR COSTS AND BUDGET DEFICITS, THEN BOI MAY EVENTUALLY BE ABLE TO RESUME ITS PAST ROLE AS A FORCEFUL MANAGER OF ITALIAN MONETARY POLICY. TO DATE, INTERNAL SOLUTION OF BOI SUCCESSION PROBLEMS HAVE BEEN FACILITATED BY EXISTENCE OF WEAK ITALIAN GOVERNMENTS. CONSEQUENTLY, POLITICAL INDEPENDENCE OF BANK HAS BEEN PRESERVED, AT LEAST FOR THE PRESENT. VOLPE

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## Message Attributes

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